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TAKING BOARDS SERIOUSLY

Jill E. Fisch*

INTRODUCTION

Today's corporate world is taking corporate governance and, in particular, the role of the board of directors, very seriously.¹ The focus on board composition and function has repeatedly surfaced in proposals for reform, from the NACD Blue Ribbon Report on Director Professionalism² and the General Motors Board of Directors Corporate Governance Guidelines³ to the ALI Principles of Corporate Governance.⁴ Commentators describe dramatic evolution of the corporate board—from a homogenous insider-dominated club to a diverse and independent body.⁵ Boards that previously served a largely ceremonial function with a minimal expenditure of time and effort can now, at least in some cases, challenge entrenched management and redirect firm decision making.⁶ Corporations, spurred on by activist institutional investors, are demanding greater involvement of directors through a variety of procedures and incentives.

The pressure on corporations to conform to "good governance" mechanisms is substantial.⁷ Corporations are subjected to highly publicized report cards and rating systems evaluating their

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¹ See, e.g., Ira M. Millstein, *The Professional Board*, 50 BUS. LAW. 1427, 1429-31 (1995) (describing recent adoption of corporate governance guidelines and codes of "best practices" by corporations, institutional investors, and various countries).

² NATIONAL ASSOCIATION OF CORPORATE DIRECTORS, REPORT OF THE NACD BLUE RIBBON COMMISSION ON DIRECTOR PROFESSIONALISM (1996) [hereinafter NACD REPORT].

³ *Id.* app. A1, at 25.

⁴ PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (1994) [hereinafter PRINCIPLES OF CORPORATE GOVERNANCE].

⁵ See, e.g., Elizabeth MacIver Neiva, *The Current State of American Corporate Governance* (Feb. 1996) (unpublished manuscript, on file with author) (describing "dramatic transformation" in behavior and structure of corporate boards over the last ten years).

⁶ See *id.*

⁷ See, e.g., Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124, 132-33 (1994) (describing recent proposals supported by institutional investors for reform of board structure).

governance practices.⁸ Institutional investors are registering protest votes at annual meetings in an effort to persuade corporations to take their boards more seriously.⁹ These efforts are supported by regulatory developments that place a growing emphasis on the use of independent boards or board committees in corporate decision making.¹⁰

Corporations are criticized for allowing their directors to serve on too many boards¹¹ or for utilizing "trophy directors" who fail to provide value.¹² To alleviate this problem, corporate attention has been focused upon obtaining qualified directors.¹³ Corporations are also striving to strengthen director participation in corporate governance, both by structuring boards and board committees to facilitate independent action and by creating compensation plans that increase the alignment of director and shareholder interests.¹⁴ Courts have embraced the model of an activist board and are indicating their willingness to impose liability on directors who fail to

⁸ See, e.g., John A. Byrne & Richard A. Melcher, *The Best & Worst Boards*, BUS. WK., Nov. 25, 1996, at 82 (ranking 25 best and worst boards on corporate governance practices); Companies Adopting Corporate Governance Guidelines: The CalPERS Lists NACD REPORT, *supra* note 2, app. A2 at 32 (listing those Fortune 300 companies providing exceptional or excellent responses to CalPERS suggestions that they consider implementing governance guidelines); *CalPERS Lists 12 Companies in Effort to Focus Attention on Corporate Reform*, 24 SEC. REG. & L. REP. (BNA) No. 13, at 420 (Mar. 27, 1992) (describing CalPERS list of companies targeted for governance reform pressure).

⁹ See Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857 (1993) (advocating use of protest vote strategy); Bruce Orwell & Joann S. Lublin, *The Plutocracy: If a Company Prospers, Should Its Directors Behave by the Book?*, WALL ST. J., Feb. 24, 1997, at 1 (describing protest votes by 24 pension plans because of their objections to Disney's corporate governance standards).

¹⁰ See, e.g., Roberta S. Karmel, *The Independent Corporate Board: A Means to What End?*, 52 GEO. WASH. L. REV. 534, 544-45 (1984) (describing SEC and NYSE regulations encouraging use of independent directors and board committees); James M. Tobin, *The Squeeze on Directors—Inside Is Out*, 49 BUS. LAW. 1707, 1739-41 (1994) (describing recent government initiatives addressed to corporate governance).

¹¹ See NACD REPORT, *supra* note 2, at 12 (recommending companies restrict the number of directorships held by members of their boards).

¹² See Judith H. Dobrynski, *When Directors Play Musical Chairs*, N.Y. TIMES, Nov. 17, 1996, § 3, at 1, (describing "trophy directors," well-connected, high-profile individuals who sit on multiple boards but provide questionable value).

¹³ See, e.g., James M. Citrin, *The Case for Courting Young Directors*, N.Y. TIMES, Sept. 10, 1995, § 3, at 12 (explaining how enhanced requirements for director independence coupled with increasing time required for director service have required corporations to expand beyond traditional criteria in order to find qualified directors).

¹⁴ See, e.g., Victor H. Boyajian, *Equity Strategies for Compensating Directors*, METROPOLITAN CORP. COUNS., Dec. 1995, at 4 (describing trend toward the use of noncash equity-based compensation for directors).

research, investigate, and ask challenging questions.¹⁵ No longer can independent directors rubber-stamp management recommendations without mastering the financial details of proposed transactions.

With the growing attention to improving corporate boards, it becomes important to evaluate the merits of the reform proposals.¹⁶ Toward that end, a number of recent empirical studies have attempted to explore the relationship between board structure and corporate performance.¹⁷ To date, this work has failed to provide clear direction about the value of restructuring the corporate board. Accordingly, studies have not resolved the debate between those who advocate the independent board as the answer to all business ills¹⁸ and those who criticize the enterprise.¹⁹

Examination of the empirical work reveals an analytic shortcoming in the reform movement—the failure of many reformers fully to consider the appropriate scope of board function. In particular, the focus on independence as a criterion for evaluating board structure may place undue emphasis on the monitoring role of the corporate board while ignoring its management function. Although director independence may enhance the board's ability to monitor effectively, this gain may come at the expense of a decline in the board's management capacity. This analysis suggests that the normative vision of independence currently embraced by the corporate governance movement is a vision that imposes costs as well as benefits upon corporations that respond to the reform pressure.

¹⁵ See, e.g., *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch., 1996) (summarizing developing case law setting forth obligations of corporate directors).

¹⁶ Academic commentators have joined institutional investors in the effort to reform board structure. See, e.g., Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Directors: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991) (proposing a corps of professional directors); Martin Lipton & Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAW. 59 (1992) (proposing changes to board size and structure to increase director involvement); Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187 (1991) (describing quinquennial election proposal).

¹⁷ See *infra* Part III.

¹⁸ See, e.g., Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 127 (1996) (describing “the management-dominated, passive board of directors” as “the most significant problem facing corporate America today”).

¹⁹ See, e.g., Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1282 (1982) (expressing skepticism that “independent directors will increase shareholder welfare”).

Recognizing that corporate boards can perform a range of monitoring and managing functions may explain the failure of market forces, despite pressure from institutional activists and regulators, to produce a single model of the corporate board corresponding to the reformers' "flavor of the month."²⁰ Moreover, the relative value of the managing and monitoring functions of the corporate board need not be uniform across the corporate spectrum. Although it may be possible to develop general predictions, the importance of managing versus monitoring is more likely a function of firm-specific characteristics.

The experience of Berkshire Hathaway, which has resisted the temptation to climb onto the bandwagon of corporate governance reform, illustrates the shortcomings of the off-the-rack model of the ideal corporate board. Berkshire Hathaway's unique attributes—from the role of owner and manager Warren Buffett to its atypical body of long-term individual investor shareholders—may justify a reduced emphasis on the monitoring board model.²¹ The Berkshire Hathaway experience demonstrates the degree to which firm-specific differences may justify variance in board structure and function. Reform proposals that reduce the board's role to monitoring and constrain a corporation's ability to choose a managing board threaten to deprive corporations of the full opportunity to utilize the board of directors as a resource. The success of companies that defy popular governance trends should signal reform advocates to proceed with caution.

I. THE DEVELOPMENT OF THE MONITORING BOARD

The separation of ownership and control in the modern public corporation creates agency costs that interfere with efficient corporate decision making.²² In an effort to reduce these agency costs, corporate law has developed a number of mechanisms to align the interests of non-owner management with the interests of share-

²⁰ See, e.g., Tobin, *supra* note 10, at 1730-35 (describing various structural reforms advocated by institutional investors).

²¹ For a general description of Berkshire Hathaway's governance structure, see Lawrence A. Cunningham, Compilation, *The Essays of Warren Buffett: Lessons for Corporate America*, 19 CARDOZO L. REV. 1, 29 (1997) [hereinafter *Buffett Essays*].

²² See, e.g., Fischel, *supra* note 19, at 1262-63 (describing agency costs inherent in the corporate form); John H. Matheson & Brent A. Olson, *Corporate Law and the Longterm Shareholder Model of Corporate Governance*, 76 MINN. L. REV. 1313, 1330-31 (1992) (explaining how the separation of ownership from control reduces the incentive for those controlling the corporation to maximize efficiency and profits and increases the incentive for management to pursue its own self interest).

holders.²³ Most recently, these efforts have focused upon the board of directors.²⁴ By empowering shareholders to elect the board and imposing fiduciary duties upon board members, corporate law creates a structure responsive to shareholder interests. Corporate law grants the board the power to make various decisions on behalf of the corporation, including the power to choose the corporate officers, set executive compensation, and review certain types of transactions.

Recent developments in corporate practice have emphasized the monitoring aspects of the board's role.²⁵ The audit committee, for example, now a staple of the public corporation,²⁶ is focused upon monitoring the internal affairs of the corporation and its compliance with financial reporting requirements.²⁷ Corporation statutes provide increasing deference to corporate decisions that are subjected to independent board scrutiny²⁸—even transactions traditionally viewed with skepticism such as those involving conflicts of interest²⁹ or the decision to dismiss a shareholder derivative suit.³⁰ Courts have emphasized that modern directors have an af-

²³ See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932) (describing separation of ownership and control and the consequent empowerment of management relative to shareholders); George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CAL. L. REV. 1073, 1075 (1995) (describing internal corporate governance mechanisms to "deter and correct managerial slack" as including the board of directors, shareholder proposals, the proxy voting process, and fiduciary duties).

²⁴ See, e.g., Laura Lin, *The Effectiveness of Outside Directors As a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 900 n.4 (1996) (describing focus on boards as "part of on-going research on ways to align the interests of management and residual risk-bearing shareholders").

²⁵ See Fischel, *supra* note 19, at 1280-81 (characterizing proposals to increase independence of boards and board committees as aimed at monitoring); Karmel, *supra* note 10, at 541-44 (describing historical development of independent boards as monitors).

²⁶ According to a 1990 study reported in the *Principles of Corporate Governance*, 99% of responding companies had audit committees. See PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 4, § 3.05 rptr. n.4.

²⁷ See John F. Olson et al., *Audit Committees of the Board of Directors: Duties and Liabilities*, P.L.I. COMMERCIAL LAW AND PRACTICE COURSE HANDBOOK SERIES 163, 167 (June 4, 1992) (describing role of audit committee as general monitor of the internal affairs of the corporation).

²⁸ See Walter Werner, *Corporation Law in Search of its Future*, 81 COLUM. L. REV. 1611, 1664 (1981) (questioning propriety of judicial deference to decisions by so-called independent directors).

²⁹ See generally Kenneth B. Davis, Jr., *Approval by Disinterested Directors*, 20 J. CORP. L. 215 (1995) (describing statutory standards addressing approval of conflict transactions by independent directors).

³⁰ See, e.g., Lin, *supra* note 24, at 904-12 (describing judicial reliance on independent board scrutiny as assurance of appropriate corporate decision making procedures).

firmative obligation to monitor a corporation's compliance efforts and can be subject to liability for their failure to do so.³¹

In an effort to enhance the board's ability to monitor effectively, commentators have identified two goals for improving board structure and function: greater director participation and greater director independence.³² Proposals to increase the use of board committees, limit the number of boards on which a director can serve,³³ and structure director compensation in a manner that rewards directors for improved firm performance,³⁴ all attempt to increase director participation. Similarly, proposals that the board adopt formal mechanisms for evaluating the CEO and other board members are designed to eliminate board passivity.³⁵

The goal of greater board independence is more difficult. Traditionally directors were classified either as employee directors or independent directors. Categorizing all non-employee directors as independent has proven problematic, however.³⁶ Although most public corporations no longer staff their boards with mostly insiders, many non-employee directors have substantial professional or personal ties to the corporation or its CEO.³⁷ These ties may interfere with a director's ability to monitor aggressively due to fears of retaliation by the CEO. Consequently, the perceived unwillingness of many non-employee directors to act independently has focused increased attention on the definition of director independence.³⁸

Recent efforts to improve board monitoring have included revising director qualification standards to encourage greater use of directors without relationships that could interfere with independ-

³¹ See, e.g., *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

³² See Davis, *supra* note 29, at 217 (describing how "corporate governance debate . . . saw independent directors as the solution to a variety of business ills and called for their increased presence and more active participation on boards and key board committees").

³³ See Dobrzynski, *supra* note 12 (questioning effectiveness of directors who hold large number of board positions).

³⁴ See, e.g., Lynn Brenner, *Are Directors Overpaid?*, CFO: MAG. FOR SENIOR FIN. EXECUTIVES, Feb. 1996, at 32 (describing efforts to create director compensation standards that improve director accountability).

³⁵ See, e.g., Ira M. Millstein, *The Evolution of the Certifying Board*, 48 BUS. LAW. 1485, 1493-95 (1993) (describing board's role in certifying executive performance).

³⁶ See *infra* notes 94-96 and accompanying text (describing complications created in defining independence for purposes of empirical analysis).

³⁷ See, e.g., Orwall & Lublin, *supra* note 9 (comparing Disney's claim that 12 of its 16 directors are independent with allegations by institutional investors that many of these so-called independent directors have personal and professional ties to Disney or its CEO, Michael Eisner).

³⁸ See, e.g., Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 611-12 (1982) (identifying psychological and social constraints on outside directors' ability to act independently).

ent action. Stricter definitions of independence range from barring all business relationships between the director and the company to focusing on personal as well as business ties.³⁹ Michigan, the one state thus far to enact a statutory definition of independent director, has one of the strictest standards. Under the Michigan statute, directors who have served on a firm's board for more than an aggregate of three years, as well as those with family or business relationships with the firm or firm employees, are not considered independent.⁴⁰

Corporations are also seeking to enhance director independence through the use of board committees.⁴¹ Committees are particularly useful for effecting board monitoring because they allow independent directors to make decisions free from the risk of domination by insiders.⁴² Thus corporations are placing responsibility for reviewing executive compensation⁴³ shareholder derivative suits⁴⁴ in the hands of independent board committees. Finally, proposals such as separating the positions of CEO and Chairman of the Board⁴⁵ or creating a lead director position attempt to direct greater control over board agenda and deliberations into the hands of outsiders.⁴⁶

³⁹ See NACD REPORT, *supra* note 2, app. C at 37 (containing definitions of director independence from various sources).

⁴⁰ See MICH. COMP. LAWS ANN. § 450.1107(3) (West 1990) (excluding from the definition of independent directors anyone who has been an officer or employee of the corporation or any of its subsidiaries or who has business ties with the company exceeding \$10,000 in the prior three years, as well as those with family relationships).

⁴¹ Melvin A. Eisenberg was one of the early advocates of independent board committees and explicitly described the duties of his proposed audit, nominating, and compensation committees in terms of monitoring functions. See MELVIN A. EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* 205-09 (1976).

⁴² *But see* Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110 (Del. 1994) (holding that threat of insider domination was sufficient to preclude application of business judgment rule to approval of cash-out merger by independent committee).

⁴³ See PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 4, § 3A.05 rptr. n.1 (describing study finding that 93% of reporting companies had compensation committees).

⁴⁴ See, e.g., Auerbach v. Bennett, 393 N.E.2d 994 (N.Y. 1979) (authorizing committee of independent directors to terminate shareholder derivative suit and applying business judgment rule to committee decision).

⁴⁵ See ROBERT A.G. MONKS & NELL MINOW, *WATCHING THE WATCHERS: CORPORATE GOVERNANCE FOR THE 21ST CENTURY* 179-80 (1996) (proposing that positions of Chairman of the Board and CEO be held by separate individuals); Editorial Round Table, *Chair and CEO: Should the Jobs be Split?*, CORP. GOVERNANCE ADVISOR, Apr.-May 1993, at 37 (addressing proposal that positions be separated in order to empower the board).

⁴⁶ See Lipton & Lorsch, *supra* note 16, at 64 (suggesting that boards chaired by the CEO maintain a lead outside director to offset the CEO's power over the information provided to the board, the board agenda, and the effectiveness of board deliberations).

The end product of these efforts is a board capable of exercising independent oversight. Restructuring board composition and procedures reduces both the presence of corporate insiders and their ability to influence board decisionmaking. This movement to take corporate boards seriously has identified monitoring management decisions as the primary governance role of the board of directors, in order to reduce the agency costs created by management decisionmaking.

II. THE COMPETING CONCEPTION—THE MANAGERIAL BOARD

Board function need not be viewed solely in terms of monitoring management. Traditionally, the board of directors was the ultimate managerial authority in the corporation. Early statutes expressly granted the board, not management, the power to run the corporation.⁴⁷ Even at the time that Berle and Means wrote their classic exposé of the separation of ownership and control, directors were defined as part of the management structure rather than shareholder representatives.⁴⁸ This definition is significant because it recognizes the distinct managing function of the board.

The duties of the managing board include advising the CEO, participating in strategic planning, and reviewing the structure of significant corporate transactions. These functions were originally carried out by a board composed predominantly of corporate executives. Insider directors had both the intimate familiarity with the corporation and the time to devote to effective management of corporate affairs. Although no bright line separates the board's managing and monitoring functions,⁴⁹ the obligations of the modern board continue to contain a management component.

The board's statutory obligations have typically emphasized the board's management responsibilities over its monitoring role. Corporation law statutes require board approval before a company

⁴⁷ See, e.g., Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80, 93 n.52 (1991) ("Early statutes absolutely required that corporations be managed by the board of directors, and these statutes were interpreted to render unenforceable agreements that substantially removed discretion from the board.").

⁴⁸ See BERLE & MEANS, *supra* note 23, at 196 (defining management as including both the directors and the officers of the corporation).

⁴⁹ See Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1064 (1993) ("[T]he line between management and monitoring is fuzzy at best.").

issues stock⁵⁰ or pays dividends,⁵¹ even when these transactions involve no element of management self-dealing. The board is responsible for reviewing and approving mergers and other changes to the corporate structure.⁵² Finally, the board is responsible for maintaining and revising the corporate charter.⁵³

Although, as described above, recent judicial decisions have characterized the board's role as that of monitor, courts also recognize the management role of the board.⁵⁴ Accordingly, courts have consistently imposed the duties of managers on outside directors.⁵⁵ This is most apparent in the merger context, in which the courts have required active participation by the board⁵⁶ and have held independent directors accountable for their failure to make sufficient efforts to maximize shareholder value.⁵⁷ Particularly when independent directors serve on special committees, courts appear to take for granted active participation extending well beyond the monitoring function.⁵⁸

⁵⁰ See, e.g., REV. MODEL BUS. CORP. ACT § 6.21(b) (Supp. 1996) (granting to board of directors the power to authorize issuance of stock) [hereinafter RMBCA].

⁵¹ See, e.g., DEL. CODE ANN. tit. 8, § 170(a) (1996) (authorizing directors to declare and pay dividends); RMBCA § 6.40(a) (Supp. 1996) (granting to board of directors the power to authorize distributions to shareholders).

⁵² See, e.g., DEL. CODE ANN. tit. 8, § 251(b) (requiring board of directors to adopt a resolution approving an agreement of merger); *id.* § 271(a) (requiring board approval for sale, lease, or exchange of all or substantially all of the corporate assets); *id.* § 275(a) (requiring board approval for dissolution).

⁵³ See, e.g., *id.* § 242(b)(1) (requiring board of directors to adopt resolution to amend the certificate of incorporation).

⁵⁴ See, e.g., *Canal Capital Corp. v. French*, No. CIV.A.11,764, 1992 WL 159008, at *3 (Del. Ch. July 2, 1992) (describing director's "managerial duties" defined as "relat[ing] to supervision, direction, and control").

⁵⁵ See generally James L. Griffith, Jr., *Director Oversight Liability: Twenty-First Century Standards and Legislative Controls on Liability*, 20 DEL. J. CORP. L. 653 (1995) (arguing that modern regulatory developments have heightened the director's duty of oversight and reduced the circumstances under which directors can delegate their managerial authority or rely on management).

⁵⁶ See, e.g., *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1285 (Del. 1989) (requiring "the intense scrutiny and participation of the independent directors" in fulfilling their duties under Revlon).

⁵⁷ See *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34, 43 (Del. 1994) (holding that directors had "the obligation of acting reasonably to seek the transaction offering the best value reasonably available to the stockholders"); see also *Citron v. Fairchild Camera and Instrument Corp.*, 569 A.2d 53, 66 (Del. 1989) (discussing "a board's active and direct role in the sale process").

⁵⁸ See, e.g., *Citron v. E.I. DuPont de Nemours & Co.*, 584 A.2d 490, 504 (Del. Ch. 1990) (describing negotiation of merger by committee of independent directors); *Kaplan v. Wyatt*, 499 A.2d 1184, 1187 (Del. 1985) (describing how, in the course of its investigation of complaint in shareholder derivative suit, two-director independent litigation committee "interviewed 140 people throughout the world").

The developments in modern corporate governance that emphasize greater director participation contemplate a board that manages as well as monitors. Commentators, activists, and even courts have begun to advocate greater director responsibility for firm performance.⁵⁹ For example, reformers have demanded that the board of directors develop a long-term strategic plan for the corporation.⁶⁰ Strategic planning is clearly a managing function.⁶¹ Choosing the corporation's executive officers and setting their compensation is also, at least in part, a management task.

Independence is not the only relevant qualification for an effective managing board. In order to formulate a strategic plan, determine whether a merger will provide long-term value, or select an executive capable of running the business, directors need a detailed familiarity with and appreciation for the nature of the corporation they oversee.⁶² Corporate insiders such as present and former employees are likely to be more familiar with the corporation than outsiders who attend twelve meetings a year. Directors in related industries, or those who have business relationships with the company, can serve as resources, contributing valuable expertise in addition to general management talent.⁶³

⁵⁹ See, e.g., Martin Lipton & Theodore N. Mirvis, *Enhanced Scrutiny and Corporate Performance: The New Frontier for Corporate Directors*, 20 DEL. J. CORP. L. 123, 126-27 (1995) (describing statements by commentators, judges, and institutional investors advocating greater director responsibility for firm performance).

⁶⁰ See *id.* at 126 (quoting speech by Chancellor William T. Allen in which Allen states that outside directors "should have an active role in the formulation of the long-term strategic, financial, and organizational goals of the corporation and should approve plans to achieve those goals").

⁶¹ See, e.g., Millstein, *supra* note 1, at 1433-35 (describing more active participation by board in strategic planning process).

⁶² See, e.g., Fischel, *supra* note 19, at 1282 (questioning whether, because independent directors are unlikely to be familiar with the business, they are capable "of making a truly important decision such as deciding whether a merger or development of a new product should go forward or whether the chief executive officer and other senior management should be replaced").

⁶³ See Telephone Interview with Elizabeth E. Bailey, Professor of Public Policy and Management at the Wharton School and Director of CSX, Philip Morris, Honeywell, and National Bancorp (Jan. 13, 1997) (describing value provided by directors in related industries and those who have business connections to the company: "you need information about the industries that you deal with") [hereinafter Bailey Interview]; see also D. Gordon Smith, *Corporate Governance and Managerial Incompetence: Lessons from Kmart*, 74 N.C. L. REV. 1037, 1138 (1996) (suggesting departure of Donald Perkins, the only outside director with retailing experience, has hampered Kmart board's ability to address poor performance).

Corporate ties also serve to motivate directors to participate more actively.⁶⁴ An insider, whose career and compensation depend on corporate performance, has a greater stake in the firm's success than an outsider, who receives \$50,000 per year regardless of whether the company does well.⁶⁵ Although Warren Buffet's holdings of Berkshire Hathaway stock are an extreme example,⁶⁶ many corporate executives also have large equity holdings in their companies which give them an incentive to be attentive to stock price.

Recent reform efforts have attempted to address the rational apathy of outside directors by encouraging stock ownership requirements and/or equity-based compensation.⁶⁷ Studies suggest, however, that few outside directors are motivated by financial rewards.⁶⁸ Indeed, most outside directors are CEOs of other major corporations and receive sufficient compensation to render trivial their compensation for serving as outside directors. Moreover, with the increasing availability and sophistication of derivative instruments, a director need not retain the undesirable firm-specific risk associated with an equity position in a company on whose board he or she sits.⁶⁹

⁶⁴ See Barry D. Baysinger & Henry N. Butler, *Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition*, 1 J.L. ECON. & ORG. 101, 115 (1985) (finding best mix of directors included a majority of directors with substantial financial ties to the company—a combination of inside directors and outside directors with significant professional relationships such as bankers, lawyers, suppliers, or customers).

⁶⁵ See Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895, 917-20 (1992) (describing general findings of correlation between inside ownership and profitability).

⁶⁶ As of February 28, 1997, Warren Buffett owned approximately 39.7% of the Class A stock of Berkshire Hathaway, representing approximately 39.5% of the aggregate voting power. BERKSHIRE HATHAWAY INC., PROXY STATEMENT 5 (May 6, 1996) [hereinafter PROXY STATEMENT].

⁶⁷ See, e.g., Brenner, *supra* note 34 (describing movement toward equity-based compensation for directors); Elson, *supra* note 18, at 130-31 (proposing compensating directors in restricted stock so they will "possess a powerful personal financial incentive to examine questionable management initiatives with the vigorous, independent, and challenging eye of an owner").

⁶⁸ See Brenner, *supra* note 34 (quoting Graef Crystal: "I've found in repeated studies that paying people in stock doesn't seem to make any difference"); Judith H. Dobrzynski, *Directors and Investors at Odds over Pay*, N.Y. TIMES, Jan. 12, 1996, at D6 (describing a survey conducted by Directorship, Inc., finding that "only seven percent of the 301 directors who responded to the survey said the opportunity to increase cash income was an important factor in their motivation for joining a board"); Lin, *supra* note 24, at 947 (finding that empirical studies have not resolved the impact of equity ownership on independent director monitoring).

⁶⁹ See Steven A. Bank, *Devaluating Reform: The Derivatives Market and Executive Compensation*, 7 DE PAUL BUS. L.J. 301, 320-22 (1995) (describing the ability of executives

III. EMPIRICAL ANALYSIS OF BOARD COMPOSITION

As the foregoing analysis suggests, the choice between a managing and a monitoring board has clear implications for board structure. To determine optimal board structure and thereby evaluate current proposals to increase board independence, it would be helpful to ascertain the relative importance of managing and monitoring on profitability. Recent empirical work has examined board structure to determine whether increased director independence can improve firm performance.⁷⁰ To date, the conclusions of these studies provide little support for the monitoring board.⁷¹ Although the studies provide some support for the proposition that independent boards are more effective monitors,⁷² evidence demonstrating a relationship between independence and profitability is in short supply.⁷³

A variety of empirical studies explore the relationship between board structure and monitoring. For example, Michael S. Weisbach finds that firms with outsider-dominated boards are more likely to remove a CEO when the firm is performing poorly than firms with insider-dominated boards.⁷⁴ Hamid Mehran shows that firms with outsider-dominated boards pay executives with a higher percentage of equity-based compensation—a structure generally perceived to reduce agency costs and tie compensation more

to enter into derivative contracts that sever the tie between the economic value of their equity-based compensation and the company's stock price). The incentive effect of equity-based compensation may also be undercut by the fact that stock price movements are likely to be only partially related to corporation-specific performance at best, thus serving as a poor indication of director effectiveness. See, e.g., *id.* at 310 (finding that only 20% of stock price variability was due to individual corporation-specific factors); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 192 (1991) (describing variety of "events in the economy as a whole" and in the industry that "have powerful effects on the price of any given firm's stock").

⁷⁰ See generally Lin, *supra* note 24, at 921-37 (summarizing empirical studies).

⁷¹ But see Elson, *supra* note 18, at 127 ("A common occurrence in many of our largest corporations is that passive boards are responsible for excessive executive compensation and, more importantly, poor corporate performance.").

⁷² See Benjamin E. Hermalin & Michael S. Weisbach, *Endogenously Chosen Boards of Directors and Their Monitoring of the CEO* 3-4 (Feb. 16, 1996) (unpublished manuscript, on file with author) (describing studies finding that independent boards provide more monitoring of CEO).

⁷³ See Lynne L. Dallas, *The Relational Board: Three Theories of Corporate Boards of Directors*, 22 J. CORP. L. 1, 18 (1996) (describing as inconclusive the results of empirical studies attempting to test the relationship between independent directors and corporate performance).

⁷⁴ See Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431, 433 (1988).

closely to firm performance.⁷⁵ Laura Lin summarizes several studies that address the manner in which outside directors employ anti-takeover devices and that conclude that outsider-dominated boards are more likely to use anti-takeover devices to increase shareholder returns than to entrench management.⁷⁶

More generally, April Klein identifies a positive relationship between the use of outside directors on monitoring committees, such as audit, compensation, and nominating committees, and the benefits of monitoring—a firm's outstanding debt and free cash flow.⁷⁷ Corporations with independent boards obtain higher gains for target shareholders in connection with tender offers, transactions that can produce a conflict between the interests of shareholders and managers.⁷⁸ Finally, stock price responses to board structure indicate a market perception that outsiders are more effective monitors. Stuart Rosenstein and Jeffrey Wyatt, for example, find that the stock market reacts favorably to announcements of the appointment of outside directors.⁷⁹ Some empirical work suggests that this reaction is misguided. Sanjai Bhagat and Bernard Black find a modest correlation between the proportion of inside directors and stock performance at certain levels.⁸⁰

Despite these findings, studies have failed to establish an empirical link between board independence and profitability.⁸¹ In one of the most recent studies, Bhagat and Black conduct a large scale survey of board composition and firm performance over a ten year

⁷⁵ See Hamid Mehran, *Executive Compensation Structure, Ownership, and Firm Performance*, 38 J. FIN. ECON. 163, 165-66 (1995).

⁷⁶ See Lin, *supra* note 24, at 930-37 (finding empirical support that outsider-dominated boards will behave in shareholders' interests in connection with tender offers, adoption of poison pills, and other control transactions).

⁷⁷ See April Klein, *Firm Productivity and Board Committee Structure* (Apr. 1995) (unpublished manuscript, on file with author).

⁷⁸ See, e.g., James F. Cotter et al., *Do Independent Directors Enhance Target Shareholder Wealth During Tender Offers?*, 43 J. FIN. ECON. 195 (1997) (finding that independent boards increase shareholder gains from tender offers and suggesting that outside directors reduce management entrenchment).

⁷⁹ See Stuart Rosenstein & Jeffrey G. Wyatt, *Outside Directors, Board Independence, and Shareholder Wealth*, 26 J. FIN. ECON. 175 (1990).

⁸⁰ See generally Sanjai Bhagat & Bernard Black, *Do Independent Directors Matter?* (1997) (unpublished manuscript, on file with author).

⁸¹ See, e.g., *id.* (finding no consistent relationship between the proportion of independent directors and various measures of firm performance); Benjamin E. Hermalin & Michael S. Weisbach, *The Effects of Board Composition and Direct Incentives on Firm Performance*, FIN. MGMT., Winter 1991, at 101, 111 (finding no relation between board composition and firm performance in study of 142 NYSE firms); Klein, *supra* note 77 (claiming no paper has found a positive association between board composition and firm performance); Mehran, *supra* note 75, at 180 (finding no statistically significant relationship between board composition and overall firm performance).

period and “find no convincing empirical support for the conventional wisdom that large company boards should consist predominantly of independent directors.”⁸² One study by Anup Agrawal and Charles Knoeber even identifies a negative relationship between corporate performance and greater outsider representation on the board.⁸³ Additionally, a few studies have found that insider representation on corporate boards enhances the board’s managerial function.⁸⁴ April Klein’s study of board committees, for example, finds a correlation between the percentage of insiders who serve on board productivity committees—defined to include strategy, investment, or finance committees⁸⁵—and firm productivity.⁸⁶ Another study finds a positive relationship between insider representation and corporate research and development spending.⁸⁷ Finally, the process of simply adding independent directors to a board to enhance board independence may be counterproductive,⁸⁸ as studies have identified a negative correlation between profitability and board size.⁸⁹

There are several possible explanations for these findings. One possible explanation is that board structure does not matter because corporate governance in general or board structure, in particular is trivial.⁹⁰ Alternatively, empirical studies may not be

⁸² Bhagat & Black, *supra* note 80, at 54.

⁸³ See Anup Agrawal & Charles R. Knoeber, *Firm Performance and Mechanisms to Control Agency Problems Between Managers and Shareholders*, 31 J. FIN. & QUANTITATIVE ANAL. 377, 379 (1996) (finding that “[b]oards of directors seem to have too many outsiders”).

⁸⁴ See John W. Byrd & Kent A. Hickman, *Do Outside Directors Monitor Managers?: Evidence from Tender Offer Bids*, 32 J. FIN. ECON. 195, 201-05 (1992) (finding that a composition of 40-60% independent directors maximizes firm’s performance in acquisitions, a subject involving both monitoring and managerial roles for board involvement).

⁸⁵ See Klein, *supra* note 77, at 26.

⁸⁶ See *id.* at 33-34.

⁸⁷ See Barry D. Baysinger et al., *Effects of Board and Ownership Structure on Corporate R&D Policy*, 34 ACAD. MGMT. J. 205 (1991).

⁸⁸ Similarly, one recent study has found no empirical evidence that separating the positions of CEO and Chairman of the Board increases performance and instead reaches the tentative conclusion that the practice of combining the roles is efficient. See James A. Brickley et al., *Corporate Leadership Structure: On the Separation of the Positions of CEO and Chairman of the Board* 5 (1995) (unpublished manuscript, on file with author).

⁸⁹ See, e.g., Theodore Eisenberg & Stefan Sundgren, *Larger Board Size, Decreasing Firm Value and Increasing Firm Solvency* (June 1996) (unpublished manuscript, on file with author) (finding a negative correlation between board size and profitability in small and medium size Finnish firms); David Yermack, *Higher Market Valuation of Companies with a Small Board of Directors*, 40 J. FIN. ECON. 185 (1996) (finding an inverse relationship between board size and firm value).

⁹⁰ See, e.g., Hermalin & Weisbach, *supra* note 81, at 111 (suggesting as one possible explanation for studies that “board composition simply does not matter”).

sufficiently sensitive to capture the relevant differences in board structure.

Defining independence appropriately for purposes of these studies is particularly difficult. Many studies rely on relatively superficial criteria in classifying directors as independent—treating employee-directors as insiders, for example, and non-employees as independent—rather than attempting the massive task of scrutinizing personal ties and business relationships.⁹¹ Given the concern that employment status alone is an insufficient indication of a director's capacity for independent action,⁹² the failure of studies to scrutinize independence more carefully may explain their findings.⁹³

Classifying directors appropriately in terms of independence is also complicated by the issue of whether the relevant criterion is independence from the company or independence from the CEO. If the board is viewed as a check on the power of the CEO in particular, instead of as a general management decisionmaker, then seemingly minor personal ties between otherwise independent business people and the CEO may hamper the board's effectiveness.⁹⁴ The board at Disney, for example, drew criticism recently because it included a number of directors who, although they lacked business relationships with the company, had financial or personal ties to Disney's CEO, Michael Eisner.⁹⁵ Director independence from the CEO, as opposed to independence from the company, is considerably more difficult to analyze because most existing reporting requirements do not provide meaningful data on

⁹¹ For example, the Hermalin and Weisbach study classified all non-employee directors as "outside directors." See Hermalin & Weisbach, *supra* note 81, at 105. More recent studies attempt to address this shortcoming. See, e.g., Cotter et al., *supra* note 78, at 12 (classifying as independent only directors with no professional ties to the company and assessing the effect of modifying this classification).

⁹² See, e.g., Orwall & Lublin, *supra* note 9 (describing institutional investor claims that outside directors on Disney's board are not truly independent). See also Jeffrey J. Clark, Kahn v. Lynch Communication Systems, Inc.: A Major Step Toward Clarifying the Role of Independent Committees, 20 DEL. J. CORP. L. 564, 581 (1995) (explaining that even independent directors may not be completely objective decision makers).

⁹³ See Dallas, *supra* note 73, at 18-19 (describing the failure of studies to distinguish between independent outside directors and those who maintain professional relationships with the corporation and concluding that it is unlikely that empirical studies can reliably test the agency cost effect of outside directors on the board).

⁹⁴ See John E. Core et al., Corporate Governance, CEO Compensation & Firm Performance 2-3 (Mar. 17, 1997) (unpublished manuscript, on file with author) (finding that CEOs at firms with weak monitoring boards are able to extract greater compensation).

⁹⁵ See Orwall & Lublin, *supra* note 9 (describing personal ties between Disney board members and Eisner).

relationships with the CEO.⁹⁶ Personal ties, in particular, are virtually impossible to uncover with any assurance of accuracy.

An alternative possibility, consistent with the findings of studies linking board composition to board function, is that board structure affects board effectiveness, but the relationship between director independence and firm performance is more complex than a linear correspondence. As the preceding analysis suggested, board function includes aspects of managing as well as monitoring. Although greater independence may enhance the board's ability to monitor, independence may also reduce the board's managerial effectiveness. Accordingly, the modern move to increased board and director independence analyzed in these studies may result in a cost/benefit trade-off that cannot be fully captured in a study that measures overall performance.⁹⁷ If both monitoring and managing are important components of board function, a study may fail to identify systematic gains from greater board independence because of the corresponding costs attributable to that independence.

IV. THE COSTS OF THE MONITORING BOARD

This Article suggests that the complexity of the relationship between board independence and firm performance may be explained by costs associated with the monitoring board, costs for which reform efforts fail adequately to account. When all other factors are equal, greater board independence enhances the board's ability to monitor; therefore increasing independence adds value. The problem, however, is that if corporate governance reform increases the relative importance of board monitoring, all other factors are not held equal.

As Professor Brudney warned more than ten years ago, there is a natural inconsistency between the board's monitoring and managing functions.⁹⁸ As a board participates actively in corporate decisionmaking, it sacrifices the capacity to monitor those decisions independently. A board that has negotiated the structure of a merger is unable to evaluate the transaction neutrally. The board that works closely to advise the CEO and other top executives sac-

⁹⁶ Consequently, better disclosure on director independence, rather than mandated standards of independence, would facilitate empirical assessments of the importance of board structure.

⁹⁷ See, e.g., Hermalin & Weisbach, *supra* note 81, at 111 (suggesting that their findings can be reconciled with evidence that outside directors are effective monitors by recognizing that inside directors also add value and that an optimal board may require a mixture of both).

⁹⁸ See Brudney, *supra* note 38, at 632-38.

rifices the distance necessary to assess executive performance critically. Moreover, to the extent that the board undertakes an affirmative role in strategic planning, the performance that the board evaluates is partially its own. Should a board judge a CEO deficient who adheres to the board's strategic plan for the corporation when that plan produces poor results?

Alternatively, a board that maintains a greater distance may risk inadequately understanding the company it is attempting to monitor.⁹⁹ Although reform proposals stress the problem of board passivity and the failure to take effective corrective action, it is also dangerous for a board to engage in excessive or inappropriate efforts to override management.¹⁰⁰ The policy reasons behind judicial adoption of the business judgment rule—including deference to the expertise of specialized management and providing management with the freedom to take risks—counsel against allowing the board to second guess management as well. Too much involvement by a monitoring board can squelch management initiative.¹⁰¹

This problem is exacerbated by institutional investor pressure for less board passivity and greater accountability. An independent board may well be responsive to calls for change by the press or dissatisfied institutional investors. Investors' dissatisfaction with corporate performance is not necessarily an indication that board action is warranted, however, and investor pressure may cause a board inappropriately to replace a CEO or change corporate strategy.¹⁰²

Another cost associated with the monitoring board is the sacrifice of substantial value offered by the availability of the board of directors as a management resource. Through the mechanism of the board of directors, corporations are able to obtain the services of talented executives at an amazingly low price.¹⁰³ It is difficult to

⁹⁹ See Bailey Interview, *supra* note 63 (explaining that participation on board by bankers, customers, and suppliers can prevent a company from making "costly errors").

¹⁰⁰ Excessive monitoring can also reduce the efficiency of corporate decision making. See, e.g., Karmel, *supra* note 10, at 552 (questioning whether the accountability effect of independent board is worth the cost of the reduction in decision making efficiency).

¹⁰¹ See, e.g., Millstein, *supra* note 1, at 1433 ("Too deep and frequent intervention by the board may make managers risk averse, conditioned to await board guidance. And if a plan is proposed by the board, rather than management, management may not have the same vested interest in carrying it through as it would have if it had developed the plan.").

¹⁰² See, e.g., Smith, *supra* note 63, at 1040-41 (questioning whether the Kmart board correctly responded to institutional pressure by forcing the departure of CEO Joe Antonini).

¹⁰³ See Stephen N. Kaplan & David Reishus, *Outside Directorships and Corporate Performance*, 27 J. FIN. ECON. 389, 389-91 (1990) (finding that effective executives are more likely to be selected as outside directors of other companies).

overstate the value of formulating long-term corporate strategy with the assistance of Warren Buffett, Henry Kravis, or Walter Scott. To the extent that board function is restricted to monitoring, a corporation makes limited use of this management resource.¹⁰⁴

Even defenders of the monitoring board acknowledge that monitoring is properly characterized as a safety valve for crisis situations. A monitoring board facilitates dealing with problems; it does not solve ineffective operating strategies or assure good performance.¹⁰⁵ The need to employ this safety valve is rare, however. Any particular company confronts crisis with limited frequency. A board that holds itself apart from corporate decisionmaking to retain neutrality in a time of crisis is a costly mechanism to maintain for crisis management.

V. REDISCOVERING BOARD FUNCTION

The costs associated with strengthening the monitoring function of the board suggest that reformers and commentators need to take board function more seriously. This does not require rejection of the monitoring board. Many companies can benefit from increased monitoring.¹⁰⁶ Corporations such as W.R. Grace,¹⁰⁷ Morrison Knudsen,¹⁰⁸ and Archer Daniels Midland¹⁰⁹ reveal a frequent correlation between consistently under-performing companies and boards that lack sufficient independence to exercise meaningful

¹⁰⁴ See, e.g., Brudney, *supra* note 38, at 611 (observing that, to the extent directors are chosen to police the integrity of management, their effectiveness is limited to that role, depriving the corporation of their other talents).

¹⁰⁵ See, e.g., Hermalin & Weisbach, *supra* note 81, at 111 (observing that "the outside-director-as-monitor literature has focused on extraordinary events . . . from which it is difficult to ascertain the value of day-to-day monitoring by outside directors").

¹⁰⁶ But see Fischel, *supra* note 19, at 1291-92 (arguing that no empirical evidence supports the conclusion that greater monitoring by boards is necessary).

¹⁰⁷ See Robert W. Lear & Boris Yavitz, *The Best and Worst Boards of 1995: Evaluating the Boardroom*, CHIEF EXECUTIVE (U.S.), Nov. 1995, at 24 (describing prior selection of W.R. Grace board as one of America's worst, based on board composition, and finding choice "borne out by subsequent events").

¹⁰⁸ See *id.* (describing Morrison Knudsen's board as one of the five worst for reasons including absence of any outside directors who had ever run or managed an industrial business, predominance of directors who were business affiliates or personal friends of the CEO or his wife, and attributing company's poor performance, in part, to the board's inattention).

¹⁰⁹ See *id.* (identifying ADM's board as one of the five worst for 1995; noting that only one director on 17-member board appears free of personal or professional connections to the CEO, and inferring relationship between board structure and ADM's involvement in price-fixing scheme).

oversight.¹¹⁰ These examples also demonstrate that increased board independence can have a meaningful impact in reducing executive excesses or improving profitability. Following the successful modernization of governance standards at W.R. Grace, including the installation of an activist independent board and a CEO unrelated to the Grace family, earnings and stock price at the company skyrocketed.¹¹¹

Current reform efforts frequently focus on cosmetic improvements to board structure rather than the relationship of that structure to firm performance. Reformers fail to recognize that managing and monitoring are distinct components of board function, thus ignoring the trade-off between monitoring and managing effectiveness. Consequently, reformers, particularly institutional investors, seek to require greater director independence and increased board monitoring in all corporations, regardless of the anticipated benefits of that monitoring or the cost imposed by sacrificing board management services.¹¹²

Recent protests by institutional investors about the lack of independence of the Disney board of directors, despite Disney's phenomenal performance,¹¹³ illustrate this concern.¹¹⁴ Investors have claimed that ten members of the sixteen member board have financial ties to the company or the CEO that compromise their independence. Investors also criticize the board's approval of CEO

¹¹⁰ See Byrne & Meleher, *supra* note 8 (describing W.R. Grace, ADM, and Morrison Knudsen as among strong performing companies that stumbled because they lacked strong and independent boards of directors); Elson, *supra* note 18, at 128 (describing performance failures at these and other companies and attributing the failures to passive boards that insufficiently held management accountable); Barbara Ettore, *Changing the Rules of the Board Games: Boards of Directors*, MGMT. REV., Apr. 1996, at 13 (describing lack of independence at ADM and Morrison Knudsen boards).

¹¹¹ See Elizabeth Lesly, *Fall from Grace*, BUS. WK., May 29, 1995, at 60 (describing increases in corporate earnings and stock price since Grace obtained a trimmed, independent board).

¹¹² See, e.g., Larry E. Ribstein, *The Mandatory Nature of the ALI Code*, 61 GEO. WASH. L. REV. 985, 993 (1993) ("[T]hrough outside directors may benefit many firms, they also may impose costs, such as interference with board functions, that outweigh monitoring benefits.").

¹¹³ Institutional activist TIAA-CREF, for example, states that it targets companies for governance reform efforts without regard to their financial performance. Empirical analysis supports this statement. See Willard T. Carleton et al., *The Influence of Institutions on Corporate Governance Through Private Negotiations: Evidence from TIAA-CREF* 23 (May 30, 1997) (unpublished manuscript, on file with author).

¹¹⁴ See, e.g., Orwall & Lublin, *supra* note 9 (describing criticisms by institutional investors that, despite Disney's success, it does not meet the corporate governance standards they demand).

Michael Eisner's compensation package¹¹⁵ even though experts acknowledge that Eisner can justifiably command the high pay based on his success in taking Disney's earnings and stock price to record highs.¹¹⁶

The preceding analysis of the managing and monitoring aspects of board function does not purport to provide a complete normative vision of the role of the board of directors. This Article does, however, take the position that efforts to construct an ideal board are unwarranted. Ideal board structure, as explained above, depends on board function.¹¹⁷ Contrasting examples such as W.R. Grace with Berkshire Hathaway, suggests that companies can have very different needs from their boards of directors, and that a universal model board may be incapable of meeting those needs.

Firm-specific characteristics may cause some corporations to require more extensive monitoring from their boards of directors. In other firms, alternative monitoring mechanisms operate as substitutes for board monitoring.¹¹⁸ Ownership structure, for example, can provide an alternative monitoring device. Firms with a controlling stockholder appear to require less monitoring by directors,¹¹⁹ and creditors may substitute for monitoring by equity-holders.¹²⁰ Institutional investors or banks may monitor management behavior directly.¹²¹ Similarly, the influence exerted by the markets in

¹¹⁵ See Paul Farhi, *Disney Chief May Reap \$771 Million from Stock Options*, WASH. POST, Feb. 22, 1997, at D1.

¹¹⁶ For example, Graef Crystal, an expert on executive compensation, defends the board's approval of Eisner's pay package as necessary to prevent competitors from hiring Eisner away from Disney. "[T]here are people out there circling the block ready to make him an offer that beats your offer." Christine Shenot, *Will Controversy Steal Disney's Show?*, ORLANDO SENTINEL, Feb. 23, 1997, at H1. Crystal further explains that "if Sony had tried to lure him away, they would have offered him Tokyo and thrown in Kyoto as a bonus." Farhi, *supra* note 115.

¹¹⁷ See Barry D. Baysinger & Henry N. Butler, *Revolution Versus Evolution in Corporation Law: The ALI's Project and the Independent Director*, 52 GEO. WASH. L. REV. 557, 578 (1984) (finding that successful corporations employ varying proportions of insiders and independent directors).

¹¹⁸ See, e.g., Agrawal & Knoeber, *supra* note 83 (finding interdependence between monitoring mechanisms); Chenchuramaiah T. Bathala & Ramesh P. Rao, *The Determinants of Board Composition: An Agency Theory Perspective*, 16 MANAGERIAL & DECISION ECON. 59 (1995) (finding empirical evidence suggesting that other monitoring mechanisms such as manager stock ownership, leverage, and high dividend payouts, may substitute for outside director monitoring).

¹¹⁹ See Black, *supra* note 65, at 917 (stating that the "available evidence suggests a generally positive link between concentrated ownership and corporate performance").

¹²⁰ See generally Triantis & Daniels, *supra* note 23 (describing role of creditors as monitors within an interactive system of corporate governance).

¹²¹ See, e.g., Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 830-49 (1992) (explaining how institutional investors

which the firm competes—the product, capital, management, and takeover markets—varies the need for board monitoring.¹²²

The nature of a corporation's business may also affect its need for board monitoring. Some industries present greater opportunities for management self-dealing. A firm with large free cash reserves, for example, or one in which direct market oversight of management decisionmaking is difficult, needs an enhanced internal monitoring structure.¹²³ In contrast, firms in regulated industries may require less monitoring by virtue of the transactional controls mandated by regulation.¹²⁴

Some firm-specific characteristics call for greater use of the managing board. Immature or rapidly growing firms that face extensive strategic planning decisions waste a valuable resource if they do not utilize the business expertise of their board members in management decisions.¹²⁵ Troubled firms, those in transition, or those with an inexperienced CEO may need to rely heavily upon the expertise of directors for managerial functions such as advising management. Engaging directors in firm management is efficient for firms that require managerial support, particularly in comparison to the cost of obtaining similar services through outside consultants.

Increased business complexity further demands that corporations involve directors in strategic planning and other management decisions. Boards that include directors with technical expertise, industry background, or experience in comparable business issues, provide a CEO with a team of experts. Their input can enhance

can serve as effective monitors); EASTERBROOK & FISCHEL, *supra* note 69, at 46 (describing ability of banks and other financial institutions to monitor corporate decisionmaking); Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 56 (1982) (defending effectiveness of banks as monitors).

¹²² See James A. Brickley & Christopher M. James, *The Takeover Market, Corporate Board Composition, and Ownership Structure: The Case of Banking*, 30 J.L. & ECON. 161 (1987) (studying possible substitution relationship between board composition and takeover regulation under state banking law).

¹²³ See Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119, 131-32 (1992) (explaining that market's capacity to monitor management is reduced for companies with excess cash); Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325, 348-350 (1995) (arguing that management prefers policy of retaining large amounts of corporate earnings to avoid the greater monitoring associated with obtaining capital through new equity issues or debt financing).

¹²⁴ See Bailey Interview, *supra* note 63 (noting that regulation may reduce opportunities for management self-dealing). Bailey also suggests that, because of the limitations on competition imposed by regulation, firms in regulated industries may have greater need for the information and expertise provided by strong directors in order to compete.

¹²⁵ See *id.*

corporate decisionmaking and prevent costly mistakes. Firms seeking to expand their international operations, for example, can benefit from the participation of outside directors with experience in the idiosyncracies of foreign markets.¹²⁶

These factors illustrate how the relative importance of board managing and monitoring can vary from firm to firm. Board structure should be tailored to the needs of a particular firm. For a growth company in a developing field, faced with a variety of strategic decisions and an inexperienced CEO, the board's role as manager may be an essential component of firm success. That role may require board members with developed industry expertise, business relationships with the firm, or even insiders. Alternatively, for an established company with large cash reserves and a dispersed shareholder body, monitoring may be more important, and the board may need board members sufficiently independent of both personal and professional relationships with management to ask tough questions. Similarly, if institutions are able to target under-performing companies in which inside directors have not managed effectively, replacing these directors with outsiders may increase monitoring capability at little cost. Furthermore, a firm's needs may change, requiring corresponding adjustments to board structure.¹²⁷

The historical evolution of the board supports the conclusion that managing is an important component of board function and that, absent regulatory pressure, firms will use a governance structure compatible with this function. This intuition is supported by "race to the top" arguments about state corporation statutes.¹²⁸ If managing functions were an insignificant aspect of modern board function, state statutes would presumably evolve away from requiring boards to manage and toward a greater emphasis on directors' monitoring obligations. This evolution has not occurred.¹²⁹ The

¹²⁶ See, e.g., Ettorre, *supra* note 110 (describing rationale behind Campbell Soup, Inc.'s addition of David K.P. Li, a Hong Kong banking CEO, to its board to assist Campbell's in taking advantage of the potentially huge China market for its products).

¹²⁷ With the departure of Warren Buffett, for example, the composition of the Berkshire Hathaway board may need to change in response.

¹²⁸ See, e.g., Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 Nw. U. L. REV. 913 (1982) (claiming that race to the bottom characterization of corporate law requires shareholders to behave irrationally); Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977) (arguing that competition in various markets causes corporations to compete to select the most efficient governance structure).

¹²⁹ See Hermalin & Weisbach, *supra* note 72, at 26-27 (suggesting that market forces limit the effect of governance reforms on board independence).

flexibility provided by state corporation law suggests that it may be efficient to allow corporations to tailor board structure to the functions most important to each individual corporation.¹³⁰

The experience of Berkshire Hathaway supports this conclusion. Berkshire Hathaway has demonstrated a consistently outstanding performance record without adopting any of the popular governance reform proposals. Judged by modern standards, Berkshire Hathaway's governance structure is decidedly antiquated. The current six member board is dominated by insiders—Warren Buffett, his wife and son, and Charles Munger, the Vice Chairman. The company only added Walter Scott, Jr., the second of the two independent directors to its board in 1988 when it listed its stock on the NYSE and was compelled by NYSE rules to have two independent directors.¹³¹ The board contains none of the structural mechanisms designed to enhance independent board action. The audit committee, which is required by NYSE rules, is the only board committee.¹³² There is no lead outside director; Warren Buffett holds both the positions of chairman of the board and CEO and clearly dominates corporate decisionmaking.

The monitoring functions provided by an independent board appear unlikely to provide substantial value to Berkshire Hathaway, however. In part, this is because, in addition to his other roles, Warren Buffett is also the controlling shareholder of the company. Studies show that controlling stockholders are able to provide effective monitoring and, accordingly, corporations with a controlling stockholder suffer few of the agency costs traditionally associated with the separation of ownership and control. Although a monitoring board is a mechanism for addressing the problems associated with the separation of ownership and control, its importance is questionable for a corporation in which that separation does not exist.

Buffett's decisionmaking at Berkshire Hathaway also appears to embody the principles of good corporate governance despite the absence of board monitoring. Hathaway's executive compensation system, for example, is both incentive-based and designed to reward managers based on productivity in the areas for which they have responsibility, rather than on overall corporate perform-

¹³⁰ See Karmel, *supra* note 10, at 544 ("Neither federal nor state law in the United States has ever dictated the composition of boards of directors, nor has the law attempted to define necessary qualifications for directors of publicly held corporations.").

¹³¹ See *Buffett Essays*, *supra* note 21, at 121.

¹³² See PROXY STATEMENT, *supra* note 66 (describing the audit committee and explaining that the company does not have standing compensation or nominating committees).

ance.¹³³ Studies have linked incentive-based management compensation to firm performance, indicating that this compensation structure is appropriate.¹³⁴ Similarly, the Berkshire Charitable Giving Program provides shareholders rather than managers with responsibility for designating the beneficiaries of Hathaway's charitable donations.¹³⁵ This structure, in contrast to ordinary corporate practice, minimizes management's ability to use charitable donations for self-dealing.¹³⁶

Rather than the corporate board serving as an unnecessary monitor, the Berkshire Hathaway board is constructed to provide value to the corporation through its managerial role. The two individuals responsible for managing the entire Berkshire Hathaway operation, Warren Buffett and Charles Munger,¹³⁷ serve on the board, providing both efficiency in board information-gathering and decisionmaking and aligning the management of the company with the formal board procedures. By involving Munger and Buffett's heirs, Howard and Susan Buffett, in board decisionmaking and strategic planning, the board structure provides those persons most likely to succeed Buffett in determining the future of the company¹³⁸ with the information and experience to facilitate the eventual management transition. This structure offers some reassurance to Hathaway stockholders concerned about the long term outlook for the company.¹³⁹

Whether Berkshire Hathaway's governance structure will continue to be effective in the future if the firm's management or ownership structure change is unclear.¹⁴⁰ Substantial changes in either are likely to require modifications in the structure and function of the Hathaway board. At the moment, however, the adoption of popular governance reform proposals is unlikely to improve Berkshire Hathaway's performance. Even the standardized governance provisions mandated by the NYSE—the requirement of two in-

¹³³ See *id.* at 28-29 (describing executive compensation policy).

¹³⁴ See, e.g., Mehran, *supra* note 75, at 165-66.

¹³⁵ See *Buffett Essays*, *supra* note 21, at 48-50 (discussing The Berkshire Program).

¹³⁶ See, e.g., Jayne W. Barnard, *Corporate Philanthropy, Executives' Pet Charities and the Agency Problem*, 41 N.Y.L. SCH. L. REV. (forthcoming 1997) (describing the potential for management self-dealing in connection with corporate charitable giving).

¹³⁷ See *Buffett Essays*, *supra* note 21, at 60 (describing Buffett and Munger as the only ones having "the managerial responsibility for the entire business").

¹³⁸ See *id.* at 39-42 (describing plans for the company after Buffett's death).

¹³⁹ See also RICHARD VANCIL, *PASSING THE BATON: MANAGING THE PROCESS OF CEO SUCCESSION* (1987) (describing the value of inside directors in facilitating the CEO succession process).

¹⁴⁰ See *Buffett Essays*, *supra* note 21, at 39-41 (describing three different owner/manager governance models and suggesting differences in the board's role among these models).

dependent directors and an audit committee—are of questionable value for Berkshire Hathaway. In the absence of pressure to conform to universal norms, it is unlikely that Berkshire Hathaway shareholders would find these requirements—and the enhanced CEO monitoring they provide—efficient or desirable. Indeed, the real challenge to Berkshire Hathaway is whether its board structure is appropriate to deal with the issue of succession upon Buffett's eventual departure.

CONCLUSION

The difficulty associated with measuring and evaluating director qualifications offers an explanation for the effort to impose a uniform board structure. It is far easier to measure the number of non-employee directors, the number of boards upon which a director sits, and the business relationships between non-employee directors and the corporation, than to predict a director's capacity for independent action on an individualized basis. The risk of evaluating corporations through good governance scorecards, however, is that investors will lose sight of firm performance and focus on criteria that appear more objective and easily measured, but ultimately prove of limited value.¹⁴¹ A system that rewards a corporation for cosmetic changes in its governance structure or that finds fault with good performers that do not conform to standardized norms risks imposing real costs upon corporate productivity.¹⁴²

This is not to dismiss efforts to facilitate more effective monitoring through greater board independence. There are constant examples of corporations like W.R. Grace, in which greater monitoring can increase firm value. It is the attempt to generalize from these examples and to assume that similar changes will increase profitability in all corporations that has led to current efforts to impose a uniform governance model on corporate America. Examples of successful corporations, such as Berkshire Hathaway, that have resisted the pressure to conform, serve as a reminder that a firm's governance structure is not an end in itself, but a means to an end. The ideal model of corporate governance is one that en-

¹⁴¹ See Catherine M. Daily et al., *Institutional Investor Activism: Follow the Leaders?* 34-35 (1996) (unpublished manuscript, on file with the Business Policy and Strategy division of the Academy of Management) (finding no evidence that institutional investor activism on corporate governance reforms has improved corporate performance).

¹⁴² See, e.g., Werner, *supra* note 28, at 1664 (describing risks to stockholders of corporations that follow the letter but not the spirit of proposed monitoring board models).

hances the ability of each firm to structure corporate decisionmaking in accordance with its particular needs, to maximize firm performance.